The Spanish economy in the third quarter of 2013

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Spain´s positive third quarter growth figures technically mark the end of the country´s recession. However, work remains to be done to correct the macroeconomic and fiscal imbalances built up in the years preceding the crisis in order for meaningful growth to begin.

Global growth picked up in the third quarter. Developed economies´ growth rates improved, albeit remaining modest, while the growth outlook for the emerging markets is still sluggish. Spain´s third quarter growth technically marks the end of recession, but the adjustment process continues and growth capacity remains limited. Overall, the fall in domestic demand has moderated, allowing for it to be offset by the external sector´s positive contribution. External and financial imbalances are correcting, with the current account entering into surplus for the first time since 1997 and both households and non-financial corporates continue to deleverage. The government has also yet to complete the fiscal consolidation underway.

Technically, the Spanish economy came out of recession in the third quarter of 2013, with reported growth of 0.1%. However, this does not mean that the crisis is over. As is clear from the current low inflation rate, continuing fall in real estate asset values and wages, credit squeeze, and faster generation of financial surpluses by households and firms to pay down their debts, the adjustment process is still on-going. Similarly, the general government also has yet to complete the major budgetary adjustment it has embarked upon.

The process of adjustment and correction of imbalances has progressed sufficiently to allow domestic demand to stabilise and the economy to emerge from recession, but insufficiently to put the crisis behind us and start a new cycle of solid growth that is able to create jobs.

Although minimal, the progress observed in the third quarter was made possible by slight growth in private consumption, and in particular, by investments in capital goods. However, construction investment continues to contract, as is also likely to be the case of public consumption. The overall outcome has been a moderation in the rate at which domestic demand is falling, such that its negative contribution to GDP growth could be offset by the external sector's positive contribution. Thus, it could be said that the process of adjustment and correction of imbalances has progressed sufficiently to allow domestic demand to stabilise and the economy to emerge from recession, but insufficiently to put

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Weak external context

World economic growth may have picked up speed in the third quarter, but it remains modest. The composite global PMI rose from an average of 52 in April-June to 54.2 in the third quarter, its highest level in six quarters. The outlook for the developed economies has improved, but growth rates look set to remain moderate, while growth in the emerging economies remains sluggish, particularly compared to the past years' figures.

In the United States the ISM index for July to September showed a marked improvement, rising to 55.8 from an average of 50.2 in the previous quarter. However, employment has performed disappointingly, with fewer jobs being created than in previous quarters. Political obstacles to extending the budget and raising the debt ceiling led to a two-week partial shutdown of the Federal Government, although the impact on the economy seems to have been limited and government debt yields did not seem to come under any particular pressure. Although this issue remains unresolved (the budgetary extension expires in mid-January and the debt ceiling in early February), it is not causing concern in international financial markets, which seem to take for granted that an agreement will be reached at the last moment.

China's rate of quarter-on-quarter growth gained speed in the third quarter, rising to 2.2%, its fastest pace since the second quarter of 2012, although in year-on-year terms China's growth rate still remains below 8%, and no return to double-digit growth is foreseen. There has also been a general improvement in Latin America, although starting from growth rates that are modest compared to those in past years.

As regards the euro zone, the composite PMI was 51.4 in the third quarter, taking it over the 50 threshold for the first time in nine quarters, while the economic sentiment index rose to 94.9, the highest it has been since 2012. All the signs therefore indicate that the recovery begun in the second quarter continued into the third, largely thanks to the reduction of sovereign-debt crisis tensions, allowing confidence to return to the peripheral economies. Nevertheless, the unemployment rate rose slightly from 12.1% to 12.2%.

The Spanish economy emerged from recession in the third quarter

Spain's GDP grew by 0.1% in the third quarter of the year, its first quarter of growth after nine consecutive quarters of contraction. This means that technically the recession is over, but given the small growth rate, and bearing in mind that GDP figures should always be taken as approximations rather than exact measures, it would be more correct to talk of stabilisation than emergence from recession. In any event, the trends suggested by the indicators seem to confirm that the economy is on track for a mild recovery, but that the start of a fresh cycle of expansion is still a long way off.

There is as of yet no information on the composition of the growth observed in the third quarter, but one could hazard a guess that domestic demand made a slightly less negative contribution than in the previous quarter, while the external sector made a similar contribution as in the preceding period.

In general, the consumption indicators, many of which already showed positive quarter-on-quarter growth rates in the second quarter, continued to grow in the third. These indicators include new vehicle registrations (although the change was influenced by the government's scrappage scheme, known as PIVE), overnight stays in hotels by Spanish residents, and retail sales, whose growth even accelerated. The consumer confidence indicator also improved markedly in the third quarter, while the retail trade confidence indicator rose to its highest level since the third quarter of 2006 (Exhibits 1.1 and 1.2). All the signs are that the favourable trend in consumption in the first half of the year, where there was a rapid levelling off after the sharp drop at the end of 2012, has been maintained in the third quarter, when consumption may have grown slightly.

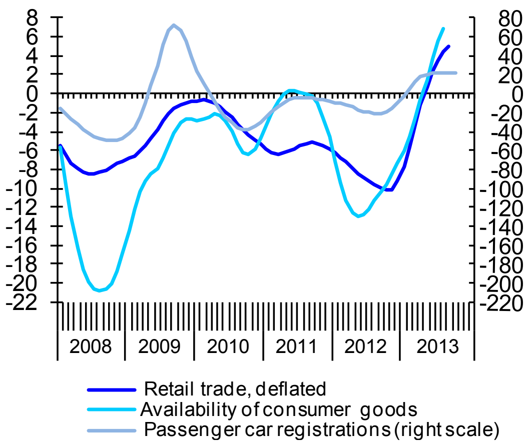
In the case of capital goods investments, the positive trend in the first two quarters of the year seems to have continued into the third. Although the indicators for this variable are highly erratic, their trend is clearly upward, with positive growth

Exhibit 1

Consumption and capital goods investment indicators

1.1 - Consumption indicators (I)

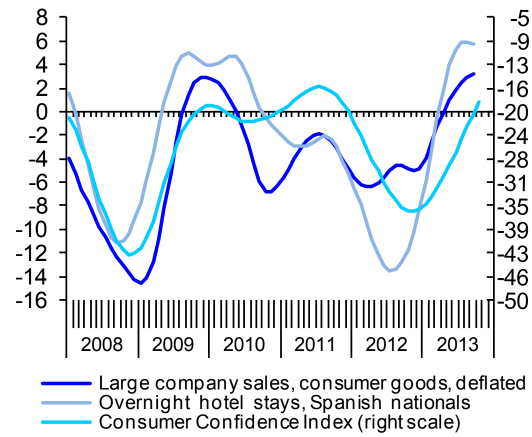
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Economy, INE, DGT and FUNCAS.

1.2 - Consumption indicators (II)

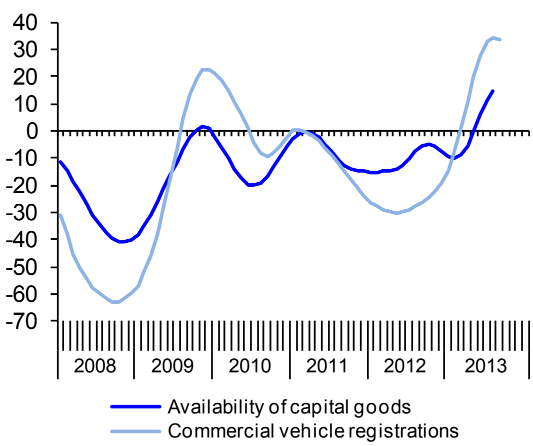
Annualised moving quarterly change in % and index (CCI), smoothed series



Sources: European Commission, INE, AEAT and FUNCAS.

1.3 - Capital goods GFCF indicators (I)

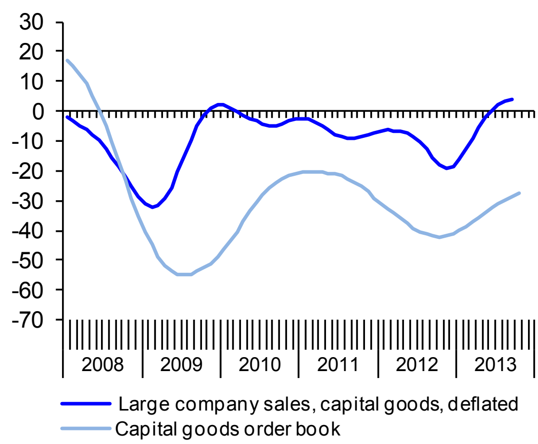
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Economy, DGT and FUNCAS.

1.4 - Capital goods GFCF indicators (II)

Annualised moving quarterly change in %,smoothed series



Sources: Ministry of Industry, AEAT and FUNCAS.

rates in both registrations of goods vehicles and the indices of availability of capital goods and sales by large capital goods companies, although the data for the quarter as a whole is incomplete (Exhibits 1.3 and 1.4).

In the case of construction investment, the official public contracting figures registered a clear deceleration in the year-on-year decline seen in the first half of the year, and even year-on-year growth in the third quarter. Moreover, the fall in new housing starts has also slowed, which could be a sign of less negative developments in residential construction in the future. Activity in the property sector remains depressed, however, with no sign of a moderation in the slump in housing sales or in prices, which have still not bottomed out (Exhibit 2.6). Since the peak, prices have fallen by almost 37% according to the National Statistics Institute (INE) data, and 29% according to the Ministry of Public Works.

In short, in the third quarter, domestic demand growth was still negative, but less so than in the previous quarter, as a result of the slight growth in private consumption and equipment investments, slowed by the drop in construction investment, and possibly also public consumption, although there is no data for the latter.

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Goods exports at constant prices in July and August (taking the two-month average) dropped relative to the average for the previous quarter, in which there was a marked upturn. If the erratic characteristic of this indicator is eliminated correctly, we obtain a trend growth signal that was 5.5% in July and August, relative to the April-June period.

Goods imports (also at constant prices) rebounded strongly in the first two quarters of the year in quarter-on-quarter terms, outpacing export growth. They subsequently dropped back again in the July-August average, but smoothing out the irregularities shows the trend to be upward. Moreover, in the July-August average the trend rate of growth was 6.2%, outpacing exports, something that has not happened since the end of 2007 (Exhibit 3.1). This is explained by the stabilisation of domestic demand, which, on slowing its decline, also slowed the contraction in imports, given how exports drive imports due to the close links between them. Nevertheless, it is still too early to say whether this is a permanent trend change in the relative progression of these two variables.

The picture given by various industrial activity indices is also mixed, although the trend is positive overall: the industrial production index registered almost no change in July-August compared to the second quarter, while sales by large industrial enterprises dropped, although at a more moderate rate than in the preceding quarter, and the deflated turnover figure grew for the first time in several quarters. Employment in the sector, measured in terms of the number of people registered in the social security system, moderated its decline. And the average PMI for the period July-September rose to just above 50, the level which indicates an increase in activity. The improvement in the industrial confidence index over the same period was also significant. Activity in the sector, therefore, may have experienced modest growth (Exhibits 2.1 and 2.2).

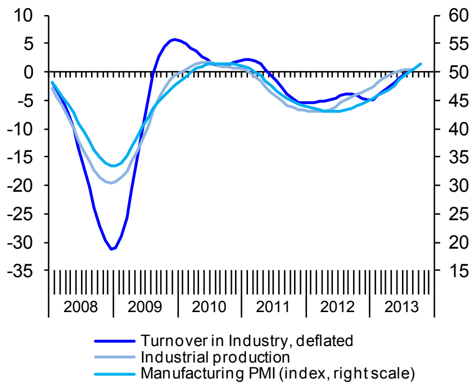
In the construction industry, indicators of activity such as cement consumption or output of construction materials tended to slow their decline, as has the number of people registered in the social security system, although the confidence index worsened over the third quarter as a whole (Exhibit 2.5).

Exhibit 2

Industrial activity, services and construction indicators

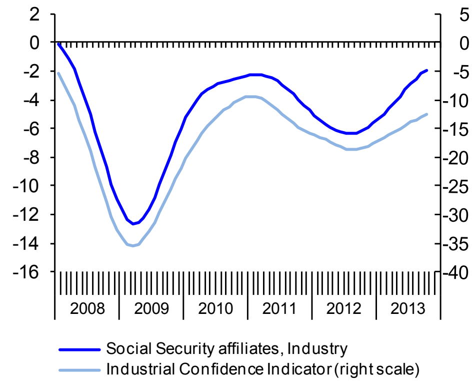
2.1 - Industrial sector indicators (I)

Annualised moving quarterly change in % and index, smoothed series



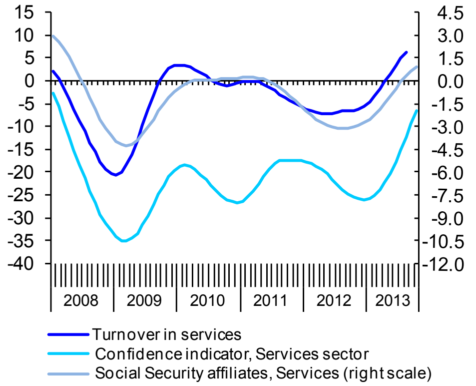
2.2 - Industrial sector indicators (II)

Annualised moving quarterly change in % and index, smoothed series



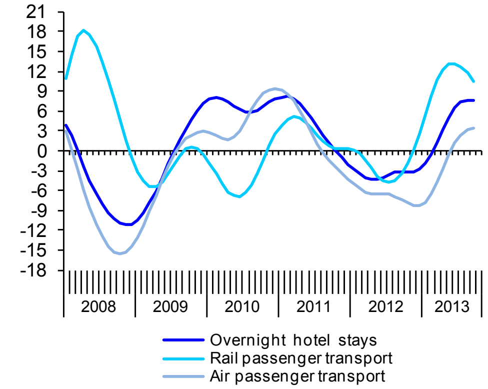
2.3 - Services indicators (I)

Annualised moving quarterly change in % and index, smoothed series



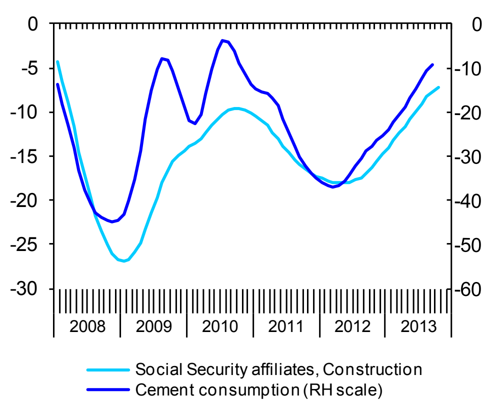
2.4 - Services indicators (II)

Annualised moving quarterly change in %, smoothed series



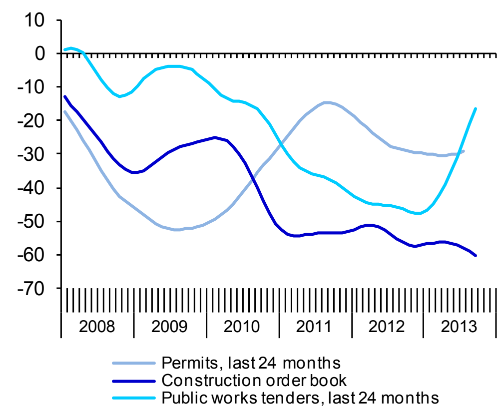
2.5 - Construction sector indicators (I)

Annualised moving quarterly change in %, smoothed series



2.6 - Construction sector indicators (II)

Annualised moving quarterly change in % and index, smoothed series



Sources: European Commission, Ministry of Labour, Ministry of Industry, Ministry of Fomento, INE, AENA, Markit Economics Ltd., RENFE, SEOPAN, OFICEMEN and FUNCAS.

As regards services, most indicators, such as the sector's activity indicator, passenger transport, overnight stays in hotels, inflows of tourists, or tourist spending, generally point towards growth in the third quarter, largely explained by the excellent tourist season. The confidence index rose over the period as a whole to reach its highest value since the start of the crisis, and there was even a slight quarter-on-quarter increase in the number of people registered in the social security system (Exhibits 2.3 and 2.4).

The trend towards a slowing of the contraction in employment (Exhibits 4.1 to 4.4) continued in the third quarter. According to the Labour Force Survey's figures, employment fell by 1.1% (on an annualised basis) with respect to the previous quarter. Nevertheless, this result is somewhat skewed by the highly uneven behaviour of farming employment, despite its representing only 4% of total employment. If we exclude farming to obtain a more representative indication of the real trend, the result is a fall in employment of just 8,500 people, implying a much slower rate than in the second quarter, in which the reduction in employment, in these same terms, came to 76,000 jobs. If, moreover, we exclude public sector employment, which is currently undergoing its own adjustment process, the final outcome is a slight increase in private-sector non-farm employment. It is worth noting that the types of jobs being lost are mainly permanent salaried posts, whereas the number of temporary contracts has grown in the last two quarters. This suggests that the labour reform has thus far not succeeded in its attempt to overcome one of the most damaging features of the Spanish labour market, namely the segmentation deriving from the high level of temporary employment.

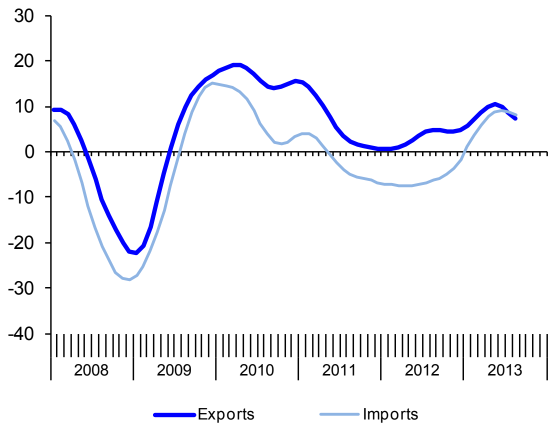
The increase in unemployment has slowed markedly, such that for several quarters it has been less than the contraction in employment. The explanation is not a decline in the labour-force participation rate, which rose in the first quarter of the year, but the shrinking of the active population, which is in turn due to the diminishing working-age population. The seasonally adjusted unemployment rate rose by a tenth of a percentage point in the third quarter to 26.5%.

Exhibit 3

External sector

3.1 - Exports/Imports at constant prices (Customs)

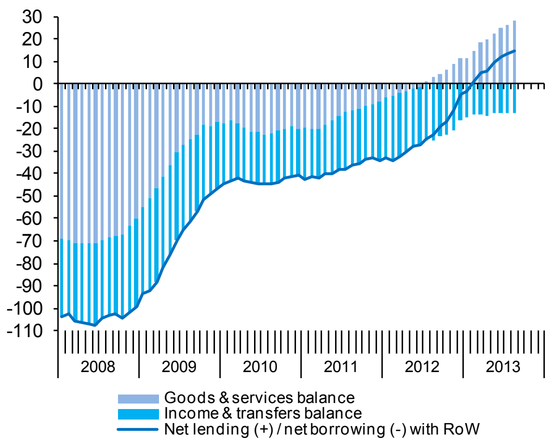
Annualised moving quarterly change in %, smoothed series



Source: Ministry of Economy.

3.2 - Balance of payments

Euro billion, cumulative last 12 months



Source: Bank of Spain.

In conclusion, the trend towards the stabilisation of the economy observed since the first quarter of the year has continued in the third quarter, in which activity even began to rise, supported by the services sector (which was mainly driven by tourism) and a timid recovery in industrial activity.

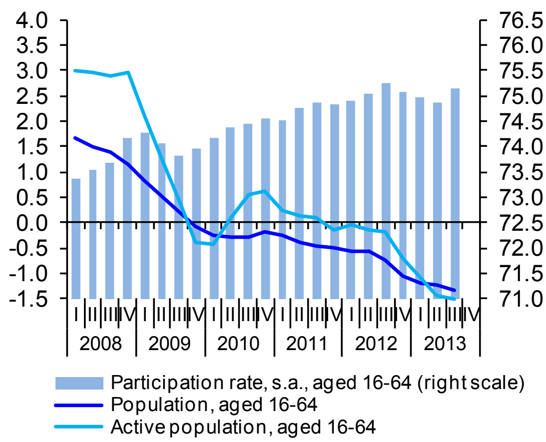
Consumer price inflation has remained on a steep downward trend since June, with a rate of 2.1% to October, when the result was -0.1%. There are several reasons for this drop: the cancelling out of a number of step effects stemming from the introduction last year of a range of measures to contain the public deficit that had an impact on final

Exhibit 4

Labour market indicators

4.1 - Labour supply

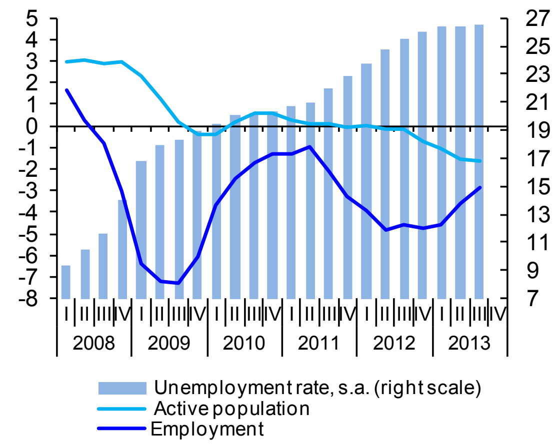
Change y-o-y in % and percentage of population aged 16-64



Source: INE (LFS).

4.2 - Employment and unemployment (LFS)

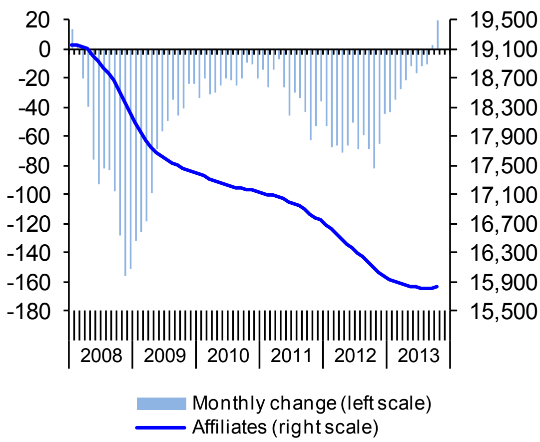
Change y-o-y in % and percentage of working age population



Source: INE (LFS).

4.3 - Social Security affiliates

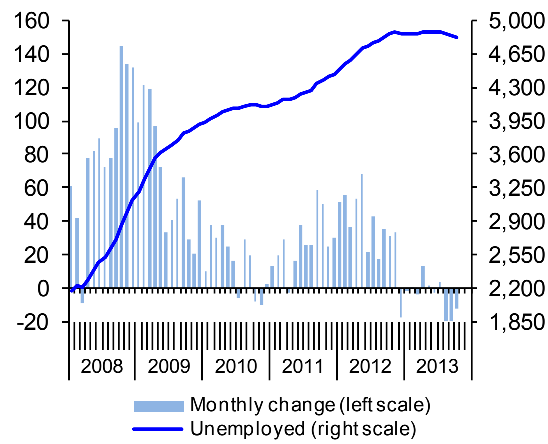
Thousands, seasonally-adjusted data



Sources: Ministry of Labour and FUNCAS.

4.4 - Registered unemployment

Thousands, seasonally-adjusted data



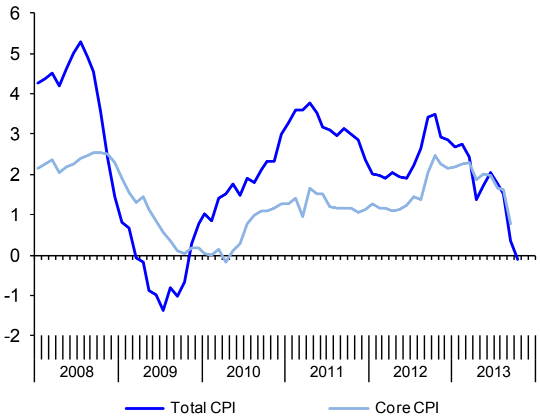
Sources: Ministry of Labour and FUNCAS.

Exhibit 5

Price indicators

5.1 - Consumer prices index

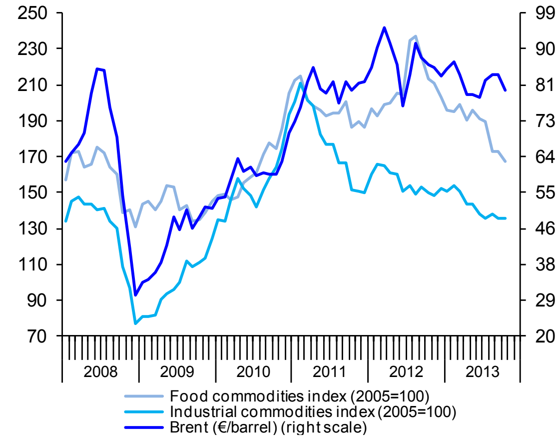
Change y-o-y in %



Source: INE (CPI).

5.2 - Commodities prices in €

Euros and index



Sources: Ministry of Economy and The Economist.

consumer prices, such as the VAT rate increase, the strong drop in the price of certain unprepared foodstuffs in September and October of this year, and the absence of structural inflationary pressures on both the demand and supply sides. The main factor on the demand side was the weaknesses of demand, as despite improving it is still a long way from exerting upward pressure on prices, and on the supply side the main factor was falling unit labour costs (Exhibits 5.1 and 5.2).

The correction of the external and financial imbalances continues

The current account balance of payments has changed sign, moving into surplus for the first time since 1997. The accumulated balance between January and August came to a surplus of 2.6 billion euros, compared with a deficit of 15.3 billion euros in the same period the previous year. This is due to the surplus on the trade balance in goods and services (thanks to the reduction in the goods deficit and the increase in the services surplus), and the smaller income balance deficit. The sum of the current account and capital balance surpluses yields a net lending position of 7.7 billion euros up to August, compared with net borrowing of 12.2 billion euros for the same period in 2012.

There has also been a major shift in the financial balance sheet. Foreign direct investment to August doubled compared to the same period the previous year. Nevertheless, portfolio investment inflows, after an upturn in late 2012 and early 2013, have once again turned negative. Something similar has happened with flows under the “other investments” heading, although in this case the net balance is in surplus due to the return of Spanish investments abroad. As a result of the foregoing, the overall balance on the financial account, excluding the Bank of Spain, was a surplus of 36.8 billion euros, compared with a deficit of 254 billion euros from January to August 2012.

The Spanish economy seems to no longer be in the predicament in which it found itself during the external credit squeeze at the height of the foreign debt crisis. This is clear both from the figures on the financial account of the balance of payments and the continued reduction of yields and spreads

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on Spanish debt (Exhibits 6.1 and 6.2).In terms of the savings-investment balance, the Spanish economy's net lending position is the result of the increased national savings rate, which came to 19.5% of GDP in the second quarter of 2013 (moving average over four quarters), and the drop in the investment rate to 18.8% of GDP. In late 2012 these rates were 18.5% and 19.8%, respectively (Exhibit 7.1).

Household savings rose in the first two quarters of this year, implying a change in trend from the decline in savings up to the fourth quarter of 2012. This rise resulted from a drop in gross disposable income that was less than that registered for consumption. If declining investment is subtracted from these increased household savings, the result is a rise in households' net lending position to 3% of GDP.

This financial surplus has made it possible to further reduce household debt levels, and therefore helped correct one of the biggest imbalances that built up during the growth phase. In the case of households, this adjustment did not really get underway until mid-2010, but since then it has gained strength. Thus, in the second quarter of 2012 household debt came to 79.9% of GDP, compared with a peak of 87.4% reached in mid-2010.

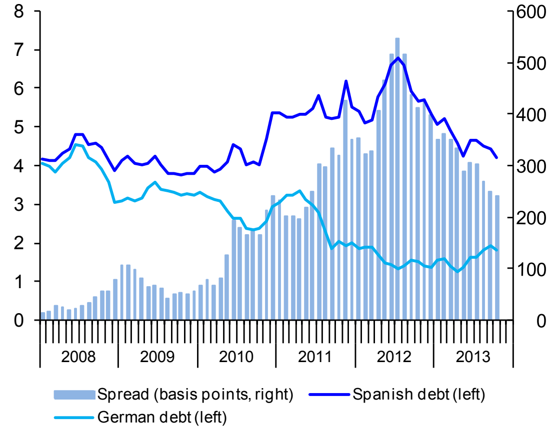
In the case of non-financial corporations, the growth in their savings gained pace considerably in the first two quarters of the year, reaching 14.7% of GDP (the moving average over four quarters), two percentage points above the level registered at the end of 2012. This progress was basically made possible by the reduction in wages and interests paid by companies. In conjunction with a faster

Exhibit 6

Financial indicators

6.1 - Government 10 years bonds rate

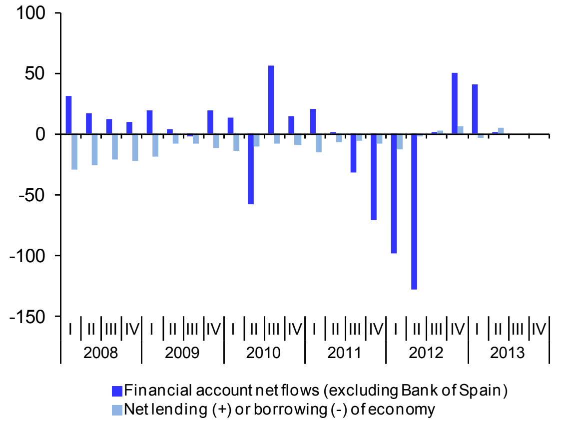
Percentage and basis points



Sources: ECB and Bank of Spain.

6.2 - Balance of payments

Euro billions



Source: Bank of Spain.

drop in nominal gross fixed capital formation (which reflects a sharp drop in its deflator, as in real terms the year-on-year drop in this variable softened in the first two quarters of the year) this has given a strong boost to non-financial corporations' net lending position, rising to 3.9% of GDP.

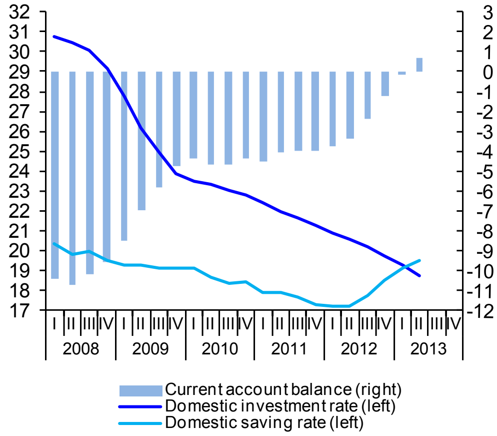
Like households, non-financial corporations utilised this surplus to speed up the deleveraging process already underway. In the second quarter their indebtedness stood at 128.3% of GDP, 16 percentage points below the peak reached in mid-2010 (Exhibits 7.2 and 7.3).

Exhibit 7

Financial imbalances

7.1 - Domestic saving, investment and current account balance

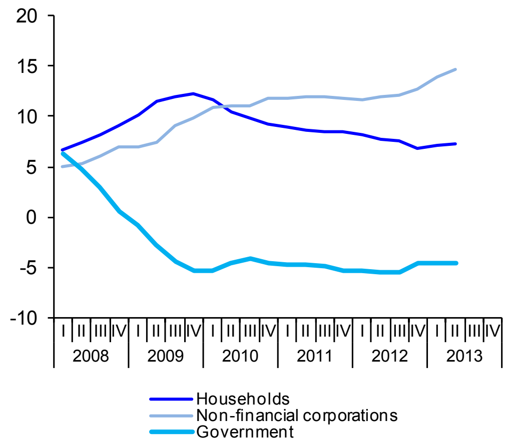
Percentage of GDP, 4-quarter moving average



Source: INE.

7.2 - Saving rates

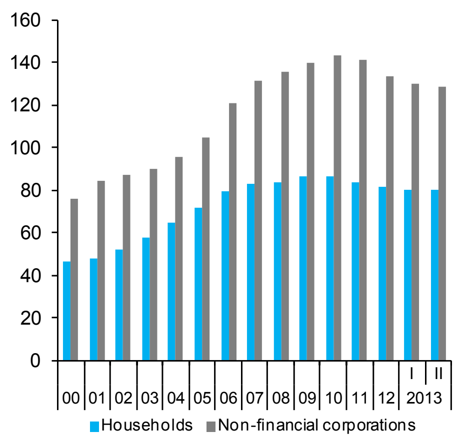
Percentage of GDP, 4-quarter moving average



Sources: INE and IGAE.

7.3 - Gross debt

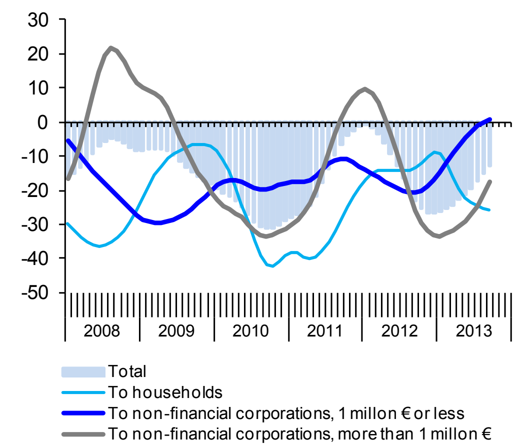
Percentage of GDP, 4-quarter moving average



Sources: Bank of Spain (Financial Accounts).

7.4 - New business loans

Annualised moving quaterly change in %, smoothed and s.a. series



Sources: Bank of Spain and FUNCAS.

The general government reduced its net borrowing from 6.8% of GDP (excluding losses deriving from the bail-out of financial institutions) in 2012, to 6.7% in the second quarter of 2013 (measured as a four-month moving average). This was the result of an increase in total resources and a decrease in total expenditure. However, current resources fell, and current expenditures rose, such that the general government savings rate became more negative: -4.6% of GDP in the second quarter of this year, one percentage point below its level in 2012. According to the Excessive Deficit Procedure, general government debt rose in the second quarter of 2013 to 92.3% of GDP, an increase of 6.3 percentage points since the end of 2012.

The stock of private sector credit continued to contract, although the rate is tending to slow: in August it fell at a year-on-year rate of 5.1% compared with a drop of 5.9% in May. This trend is more clearly visible in new credit to businesses and households, which fell by 13% in the third quarter at an annualised quarter-on-quarter rate, compared with a drop of 20.5% in the previous quarter. Indeed, in the case of new credit of less than 1 million euros to non-financial corporations, there was even a quarter-on-quarter rise of 4.9%, although it is too early to say if this progress will continue in the coming quarters. In any event, this suggests that the credit squeeze, although still persisting, is beginning to moderate (Exhibit 7.4).

In conclusion, the adjustment processes continue. Internal demand remains weak and the economy's growth capacity will continue to be limited for some time to come, despite the favourable progress of exports.